

No. 13676

**In the United States Court of Appeals
for the Ninth Circuit**

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BEAR FILM Co., a CORPORATION, RESPONDENT

*ON PETITION FOR REVIEW OF THE DECISION OF THE TAX
COURT OF THE UNITED STATES*

BRIEF FOR THE PETITIONER

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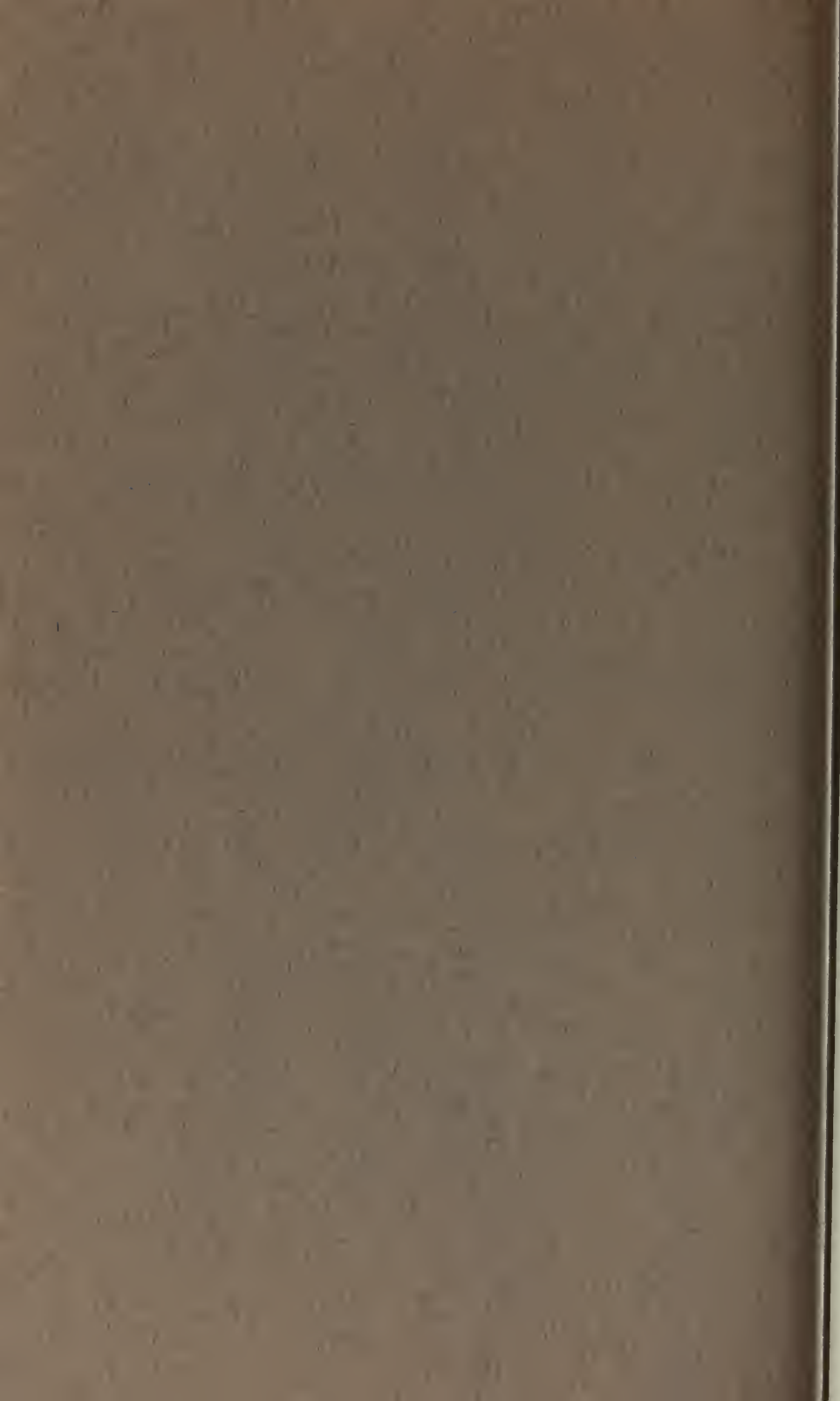
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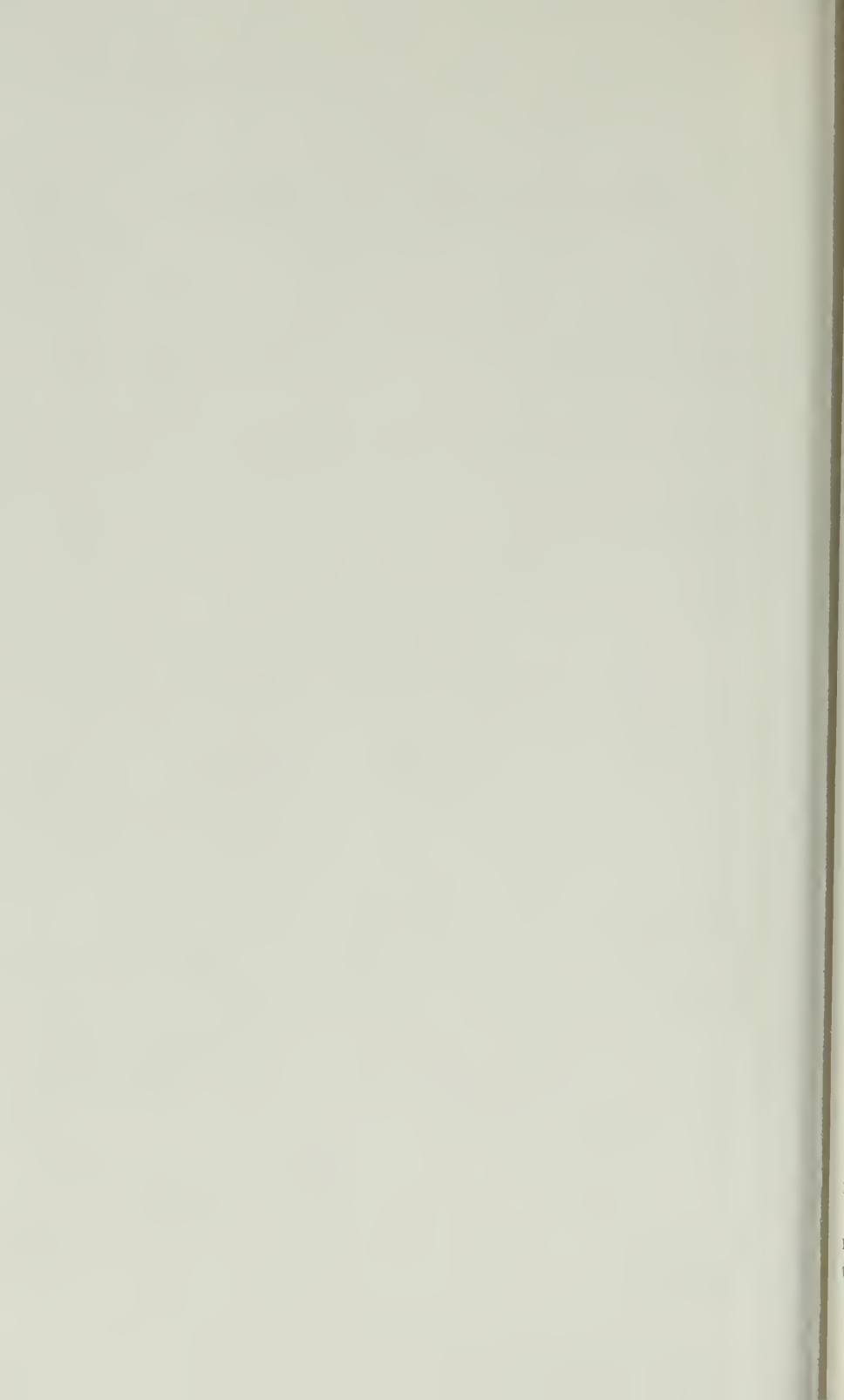
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OPINION BELOW

The opinion of the Tax Court (R. 185-199) is reported at 18 T. C. 354.

JURISDICTION

The petition for review (R. 200-202)¹ involves a deficiency in corporate income taxes for the taxable year 1945 in the amount of \$25,376.20 (R. 206-207). A notice of deficiency was mailed to taxpayer on May 22, 1950 (R. 165, 169, 182). Taxpayer filed a petition for redetermination with the Tax Court on July 28, 1950 (R. 163, 165-181), under the provisions of Section 272 of the Internal Revenue Code. The decision of the Tax Court, sustaining in part and overruling in part the Commissioner's deter-

¹ This Court approved a stipulation providing that a single joint record be printed in the instant case and the related case of *Vincent v. Commissioner* (Docket No. 13649), now pending on review before this Court (R. 208-209). Separate briefs will be written in the cases.

mination of deficiency, was entered July 24, 1952 (R. 199-200). The case is brought to this Court by a petition for review filed by the Commissioner on October 14, 1952 (R. 200-202), pursuant to the provisions of Section 1141 (a), Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Whether the sum of \$61,000 paid by taxpayer pursuant to a state court decree construed by the Tax Court as having effected a "compound novation", represented, as held by the Tax Court, additional compensation for services rendered which was deductible by taxpayer for the year 1946 under Section 23 (a) (1) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses*.—

(1) *Trade or Business Expenses*.—

(A) *In General*.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *.

* * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period

(fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; * * * * *

* * * * *

(26 U. S. C. 1946 ed., Sec. 41.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U. S. C. 1946 ed., Sec. 43.)

SEC. 48. DEFINITIONS.

When used in this chapter—

(a) *Taxable Year*.—"Taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under this Part. * * *

* * * * *

(c) "*Paid or Incurred*," "*Paid or Accrued*."—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * * *

(26 U. S. C. 1946 ed., Sec. 48.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.43-1. "*Paid or Incurred*" and "*Paid or Accrued*."—(a) The terms "paid or incurred" and

“paid or accrued” will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) * * *

* * * * *

STATEMENT

The facts have been stipulated (R. 183-185) and, as stipulated and found by the Tax Court (R. 187-194), may be summarized as follows:

Taxpayer (sometimes hereinafter referred to as Bear) is a California corporation which kept its books and filed its returns on an accrual basis. One Oscar Hansen was president of Bear from the time of its incorporation until his death, intestate, in 1929, and owned all the stock of that corporation consisting of 2,500 shares of preferred and 2,500 shares of common stock (R. 1878-18).

Oscar Hansen and his wife separated in 1920 and were divorced in 1922. In 1920 Oscar's wife and daughter Virginia (taxpayer in *Vincent v. Commissioner*, Docket No. 13649, now pending on review before this Court) went to live in Michigan where Virginia continued to reside until 1940 when she returned to California. At some time prior to 1945, Virginia remarried and became known as Virginia Hansen Vincent (referred to herein as Virginia) (R. 187-188).

Upon the death of her father in 1929, Virginia, then 13 years old, was his sole surviving heir. Other survivors were his mother, Josephine Hansen, and his brothers, Albert and Charles Hansen. Oscar Hansen was close to his mother and lived with her after he was separated from his wife (R. 188).

During 1926 and 1927, Oscar Hansen conveyed all his stock in Bear to his mother, Josephine, as trustee, in

trust, for himself as beneficiary of the trust. He never at any time revoked or changed the terms of the trust and in fact, and at law, was the beneficial owner of all of the preferred and common stock of Bear, and Josephine had a bare legal title thereto. Upon his death, Josephine concealed the fact that she held the bare legal title as trustee, and the stock was not included in the assets of the estate of Oscar Hansen, of which Josephine was one of the administrators (R. 188).

After Oscar's death, a brother Albert was persuaded by the mother, Josephine, to resign from the faculty of Purdue University and to manage the business of Bear. In 1929, Albert was elected president and a director of the corporation, and thereafter managed the business of Bear until his death in 1940 (R. 188-189).

In 1930, Josephine assigned all the preferred and common stock of Bear to Albert, who, in turn, transferred some of the stock to a trust for the benefit of his son Robert. Upon the death of Albert, the rest of the stock was held in trust for the benefit of his wife, Alice Hansen, and their children, Robert and Florence (R. 189).

After the death of Oscar, dividends in the total amount of \$95,000 were declared on all of Bear's stock, but only \$61,000 thereof was paid. The payments were made in various amounts from December 31, 1937, to August 13, 1941, to Albert and his estate (R. 189).

Bear also paid Albert a salary for his services as president and manager which aggregated \$81,210.09 during his lifetime (R. 189).

In August, 1940, Virginia, daughter of Oscar, filed suit in the Superior Court for the County of San Francisco against Bear, the executrix of Albert Hansen's estate, and

others, for the recovery of all the stock of Bear, and for other relief. The suit was instituted upon the basis of information which led her to believe that she was the lawful owner of all of the Bear stock, and a decision of the Superior Court in her favor was entered on July 2, 1943.² In 1946, the Supreme Court of California affirmed³ the decision of the Superior Court which then became final (R. 189-190). The findings of fact, conclusions of law (R. 19-110), and judgment (R. 111-114) of the Superior Court were received in evidence by the Tax Court in the instant proceeding and were incorporated by reference in the findings of the Tax Court (R. 190).

Insofar as material, and in substance, the Superior Court concluded and held (1) that at the time of his death, Oscar Hansen was the equitable owner of all of the Bear stock, and that Virginia, as his sole heir, became the equitable owner thereof (R. 108, 112, 190); (2) that (a) Bear held, as trustee, for Virginia 500 shares of its common and 500 shares of its preferred stock, which formerly stood in the name of Albert Hansen and which were transferred by him to it in 1939 in trust for his son Robert Carmody Hansen, and (b) that Alice Carmody Hansen, as executrix of the estate of Albert Hansen, held 2,000 shares each of the common and preferred stock of Bear as trustee for Virginia (R. 108, 112, 190). The Superior Court further found Albert Hansen could not have honestly believed that Josephine Hansen owned the stock involved and that he was possessed of knowledge, which put him, as a prudent man, on inquiry as to the real ownership of the stock, and further that he held the

² The opinion of that court is not officially reported.

³ Reported as *Hansen v. Bear Film Co.*, 28 Cal. 2d 154, 168 P. 2d 946.

bare legal title to the stock subject to the claims of the true owner (R. 49-50, 51, 190-191). Nevertheless, that court found that Albert Hansen gave up his professional career to assume the management of Bear, that he had performed his duties with skill and ability, and that he had increased the business and more than doubled its value and worth (R. 51-52, 77, 90, 92-93, 191). The Superior Court also found that the reasonable value of Albert Hansen's services to the corporation for the entire period during which he rendered services was not less than \$81,210.09, the compensation he had been paid, plus \$61,000, or a total of \$142,210.09 (R. 107-108, 191).

In addition, the Superior Court directed Bear and the estate of Albert Hansen to transfer the legal title of all of the preferred and common stock of Bear to Virginia and to make delivery of the stock to her. That court also decreed that Virginia recover judgment against Bear for the sum of \$61,000 principal, "representing dividends declared and paid on the foregoing stock subsequent to April 26, 1929, together with interest thereon" in the sum of \$17,676.09; that "all right on the part of any person to recover for dividends declared but not paid (including all credits now appearing on the books of said corporation for said unpaid dividends) shall be cancelled and all such dividends shall be cancelled"; and that Bear "is not entitled to, and it shall be decreed that it may not demand, attempt to collect or recover from the defendants or any of them the whole or any part of the sums heretofore paid Albert A. Hansen or his estate as or on account of dividends" (R. 108-109, 112-113).

In 1946, Bear paid the judgment "insofar as it ran against" itself; the amounts paid included \$61,000 paid pursuant to paragraph 6 of the order of the California

Superior Court (R. 184). That paragraph provided, in part, that Virginia "do have and recover judgment against Bear Film Co. for the sum of \$61,000.00 principal, representing dividends declared and paid on the foregoing stock subsequent to April 26, 1929, * * *" (R. 113).

Bear sustained a net operating loss for the year 1946 and was entitled to a loss carryback to the year 1945 under Section 122 of the Code. The Commissioner reduced the amount of the net operating loss for 1946, which resulted in a corresponding reduction of the amount of the loss carryback deduction in 1945. This reduction resulted in part from the disallowance, as a business expense deduction for 1946, of the \$61,000 paid pursuant to the judgment of the Superior Court (R. 179). Accordingly, the Commissioner determined a deficiency in Bear's income tax for 1945 in the total amount of \$25,376.20 (R. 169, 186).

On petition for review filed by Bear with the Tax Court, one of the issues involved related to the deductibility under Section 23 (a) (1) (A) of the Code, of the sum of \$61,000 payment of which, as stated above, was made by Bear during 1946 pursuant to the decree of the California court (R. 186-187). The Tax Court held, upon the basis of its interpretation (R. 146-147, 195-196) of the decree and orders of the Superior Court that, in 1946, Bear "for the first time discharged its obligation to pay an additional \$61,000 compensation for the services of Albert Hansen, deceased." Accordingly, the Tax Court found and held that Bear incurred and paid a business expense in the amount of \$61,000 in 1946 with respect to which it was entitled to a business expense deduction under Section 23 (a) (1) (A) of the Code (R. 191-192, 195-196).

STATEMENT OF POINTS TO BE URGED

The statement of points which are relied upon by the Commissioner as the basis for the proceeding are set forth at pages 206-207 of the printed record. In substance they are that the Tax Court erred in its finding and conclusion that taxpayer was entitled to a business expense deduction with respect to the payment by it of the sum of \$61,000 which it construed as representing payment of compensation for services.

SUMMARY OF ARGUMENT

The petition for review of the decision of the Tax Court in the instant case was filed for protective purposes in the event that this Court should reject the theory on which the Tax Court decided the issue presented in the case of *Vincent v. Commissioner, infra*, now pending on review before this Court. It is the position of the Commissioner that the decision herein is correct and that it should, except for the eventuality mentioned, be affirmed.

ARGUMENT

The issue involved in this appeal is related to one of the issues in the case of *Vincent v. Commissioner* (Docket No. 13649), now pending on review before this Court. Both issues arise from the same basic facts, consisting of the findings of fact, conclusions of law, and judgment of the Superior Court of California in and for the City and County of San Francisco (R. 17-114), which were stipulated as facts in both the instant case and the case of *Vincent v. Commissioner, supra* (R. 14, 183-184). The stipulated facts were accepted and found as facts by the Tax Court in each of the related cases (R. 126, 187).

The decision of the Tax Court in each of the cases was

based upon its interpretation of the decree and orders of the California Superior Court which it construed to mean (R. 146-147, 195-196) that Albert's estate was obligated in 1946 to make restitution to Virginia of \$61,000 dividends improperly received by the estate or by Albert; that in 1946 Bear became obligated to pay additional compensation for Albert's services in the amount of \$61,000; and that a "compound novation" was effected by the decree of the court whereby Bear discharged the obligation of Albert's estate to make restitution of \$61,000 accumulated dividends to Virginia, thereby satisfying its obligation to pay the estate for Albert's compensation, \$61,000.

Under the judgment of the Superior Court, Virginia recovered, during the taxable year 1946, 5,000 shares of Bear stock, having a value of \$305,850, \$61,000 in cash, representing dividends, and \$63,082 in cash, representing interest (R. 133-134). She did not include in her income for 1946, however, the sum of \$61,000 which Bear paid her pursuant to the decree of the Superior Court, contending, as the Tax Court stated (R. 145), "* * * that the sum in question represents damages and that it is, therefore, not taxable as income under section 22 (b) (5)." The Commissioner, on the other hand, determined that this sum represented dividends on the Bear stock, and, accordingly, that it was taxable income under Section 22 (a) of the Code (R. 139-140).

Following its interpretation of the judgment of the California court, the Tax Court sustained the Commissioner in his determination that the sum of \$61,000, received by Virginia in 1946, represented "accumulated dividends" owed to her by the estate of Albert, and there-

fore was taxable as income to her under Section 22 (a) of the Code (R. 147).

Correspondingly, the Tax Court held that in 1946 Bear "for the first time discharged its obligation to pay an additional \$61,000 compensation for the services of Albert Hansen", or to state it differently, Albert's estate constructively received in 1946 \$61,000 compensation for Albert's services and his estate made restitution of \$61,000 dividends to Virginia through Bear under the novation which was effected by the Superior Court's order. Accordingly, the Tax Court found and held that Bear incurred and paid a business expense in the amount of \$61,000 in 1946 with respect to which it was entitled to a business expense deduction under Section 23 (a) (1) (A) of the Code, *supra* (R. 191-192, 195-196).

It is obvious, as pointed out by the Tax Court (R. 146), that by its judgment the California Supreme Court devised a way of obviating a suit by Bear against the estate of Albert Hansen to recover dividends improperly paid by finding that he had rendered services having a value of \$61,000 in excess of what Bear had paid to him as salary or compensation for services, so that what had been paid by Bear to Albert Hansen or his estate as dividends was to be deemed to have been additional payment of compensation for his services, with the result that Bear was ordered to pay \$61,000 to Virginia as dividends. As further pointed out by the Tax Court (R. 146), these orders of the Superior Court also eliminated the formal steps of a payment of additional compensation by Bear to the Albert Hansen estate, the return of erroneously paid dividends by the estate to Bear, and the payment of the

dividends by Bear to Virginia, all obligations involving the same amount, namely, \$61,000.

It is the position of the Commissioner that the Tax Court correctly decided both the instant case and also that of *Vincent v. Commissioner, supra*. The petition for review of the decision in the instant case was filed for protective purposes only in the event that, upon review of the decision of the Tax Court in the *Vincent* case, this Court should reject the theory on which the Tax Court decided that case and formulate a new and different theory which might change the tax consequences with respect to Bear. In such an eventuality, the Commissioner was and is of the opinion that, since the tax questions in both cases arise from the same factual situation, the decision of the Tax Court in the instant case should be kept open for review by this Court.

CONCLUSION

The decision of the Tax Court herein is correct and, except for the eventuality above mentioned, should be affirmed.

Respectfully submitted.

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